Scottish Borders COUNCIL

STRATEGIC INVESTMENT REVIEW

Report by Executive Director Finance & Regulatory

JOINT MEETING OF PENSION FUND COMMITTEE AND PENSION FUND BOARD

10 June 2021

1 PURPOSE AND SUMMARY

1.1 **The report provides the Committee and Board with an update on the outcome of the 2021 Strategic Investment Review and presents the resulting recommendations for the revised asset allocation.**

1.2 The Investment strategy is a key to ensuring assets continue to grow to meet the long term liabilities of the Fund and that as far as possible the contribution rates paid by employers remain stable.

1.3 A review of the current strategy has been undertaken by Isio, the Funds' Investment Advisor, in consultation with officers and the findings are detailed in Appendix 1. A workshop was held with the Investment and Performance Sub Committee of the 25 May 2021 to discuss recommended changes arising from the review. Para 5.5 details the recommended revised

2 STATUS OF REPORT

2.1 Due to the timing of the Investment and Performance Sub Committee the report is currently undergoing consultation. Comments received from the consultation will be reported at the meeting.

3 RECOMMENDATIONS

3.1 **It is recommended that the Pension Fund Committee:-**

(a) Agree the investment strategy as summarised in para 5.5 and detailed in appendix 1.

(b) Delegate authority to the Executive Director Finance and Regulatory, in consultation with the Chair of the Pension Fund Committee, and based on the advice of the Investment Advisor to:

i) implement the outcome of the 2021 review of the Funds' equity mandates;

ii) terminate the UBS Property Fund; and,

iii) procure a new Infrastructure Manager; and,
iv) Terminate the current passive equity mandate, and procure a new passive equity manager to replace UBS.

(c) Request regular update reports as the implementation of the revised strategy progresses.

4 BACKGROUND

4.1 The Pension Fund is required by the Local Government Pension Scheme (LGPS) Regulations to have an up-to-date Statement of Investment Principles (SIP). A key part of the SIP is the strategic asset allocation which sets the allocation of investments across the different asset classes.

4.2 The Funds primary aim of the Fund is "To provide for members' pension and lump sum benefits on their retirement or for their dependants' benefits on death before or after retirement, on a defined benefits basis". To meet this aim the Pension Fund must ensure it sets levels of contributions that will build up a fund of assets sufficient to meet all future benefit payments.

4.3 The Fund while setting the contributions rates aims to ensure the rates payable by employers are as stable as possible. To reduce the volatility of contribution rates the Fund must ensure there is stability and the required level of returns from the investments.

4.4 The last review of the strategic asset allocation was undertaken in September 2018 following the 2017 tri-annual revaluation and the appointment of KPMG the then Investment Advisor. The outcome of this review was incorporated into the current SIP and good progress has been made with respect to implementation.

4.5 The results of the most recent triennial valuation on 31 March 2020 has shown the updated funding position to be 110%. The employer contribution rates agreed as part of the2020 valuation process require the Pension Funds investments to deliver a return of at least 3.8% per annum to support the funding position.

5 STRATEGIC REVIEW

5.1 Isio, the Funds' current Investment Advisors, has now undertaken a health check of the current investments within the Fund. The Fund has performed well, and has over the last 10 years consistently produced a positive return above benchmark over a 3 year rolling period. The Fund has also, as seen in appendix 1, invested at lower volatility levels than other Scottish LGPS funds while delivering comparable investment returns through a well-diversified portfolio of assets.

5.2 Much of the recent strong performance has been achieved from the Funds' equity investments. The current allocation of 40% of assets to equities is split between UK and Global over four portfolios. The current balance is tilted toward UK equites with an allocation of 25%, spread over active and passive management. The Fund has over the last two years, as part of its Responsible Investment Policy, moved all of its equity investments with Morgan Stanley into the Global Sustain fund which excludes tobacco, alcohol and stocks in carbon polluting businesses. The review undertaken with Isio supports maintaining the current 40% allocation to equities but recommends restructuring the existing portfolios to target a more balanced, robust and sustainable approach. The recommendation looks to move 10% into an ESG focused "passive" fund, requiring the replacement of the

current manager UBS with a new provider, and to spread the remaining 30% between sustainable funds with Morgan Stanley and Baillie Gifford. With respect to investments managed by Baillie Gifford rebalancing the fund to focus less on UK investments and more on a Global mandate with a tilt towards ESG is recommended.

5.3 The Fund currently also has a 10% allocation to balanced property with UBS which is maintained in a "fund of funds" portfolio. The property mandate, despite a number of changes over the years to reduce the number of individual fund managers, continues to cause concern around its performance and direction. It is now recommended the Pension Fund fully withdraws from its balanced property mandate with UBS. There are a number of options on how this withdrawal can be achieved, with different costs and different likely durations to be evaluated in determining the optimal exit strategy. Further discussion and investigation will be required to ensure the Fund withdraws from its UBS property mandate and delegated authority is sought to ensure this can be delivered in the most cost effective and timely manner.

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5.5 The table below gives a summary of the recommendations of the review against the current approved strategy. Appendix 1 details the full findings of the review.

Asset Group	Current Allocation	Recommend Allocation	Move-ment
Passive Equities	6%	10%	4%
Active Equities	34%	30%	(4%)
Total Equities	**40%**	**40%**	**-**
Diversified Alternatives	7.5%	4%	(3.5%)
Diversified Credit	10%	10%	-
Index Linked Gilts	5%	6%	1%
Direct Lending/Private Credit	10%	10%	-
Junior Infrastructure Debt	2.5%	2.5%	-
Senior Infrastructure Debt	5%	5%	-
Property - Balanced	5%	-	(5%)
Property – Long Lease	10%	12%	2%
Property – Residential		2.5%	2.5%
Infrastructure Equity	5%	8%	3%

5.6 The transition to the recommended revised strategy will take time and require disinvestment of some funds and the appointment of new funds. It is proposed this is done on a phased based as detailed in appendix 1, using existing managers where possible to minimise the cost of transition. The timescales for moving to the new strategy is estimated at this point to be around 12-18 months and any revision to this timescale will be reported to committee.

5.7 For the additional allocation to Infrastructure equity it is proposed the additional funds are allocated to a new pooled investment Fund. This will require a new manager to be appointed but will minimise the future administrative burden and allow the funds to be invested quickly.

6 IMPLICATIONS

6.1 Financial

(a) The revised asset allocation will require the establishment of new portfolios within the Fund. To minimise the costs of procurement Officers in conjunction with the Investment Advisor will investigate the use of existing Managers where possible.

(b) The withdrawal from UBS Property portfolio could result in a realised loss. Officers will work with Isio and UBS to look at way to minimize these costs.

6.2 Risk and Mitigations

(a) The Fund is becoming more mature as the number of deferred and retired members now exceeds those currently contributing. This has resulted in a negative fund cashflow as the monthly payments to Pensioners are now greater than the contributions collected through payroll. The Fund therefore needs to generate more liquid cash in order to pay pensioners and the current arrangements, whereby dividends are directly reinvested back into the portfolios. The mix of investments required to meet the funds cashflow obligations requires to be kept under review to ensure the Fund generates the monthly cash income required by the Fund to allow payment of pensioners.

(b) The terms of the scheme allow for annual inflation linked increases in pension payments. There is a risk that this may result in increased liabilities which outstrip any the future growth in investments. To mitigate this risk the investments require to be diversified into assets which match the inflationary growth in liabilities in the best way possible.

(c) In line with the corporate risk management approach, the Pension Fund maintains a full risk register which is fully reviewed on an annual basis and reports are submitted to the Joint Pension Fund Committee and Board on a quarterly basis updates on ongoing mitigation actions. Any new risks identified are added to the risk register on an ongoing basis.

6.3 **Integrated Impact Assessment**
There is no impact or relevance to Equality Duty or the Fairer Scotland Duty for this report. This is routine good governance required under the Local Government Pension Scheme (Governance) (Scotland) Regulations 2014. Nevertheless, a light touch assessment has been conducted and this will be published on SBC's Equality and Diversity Pages of the website to demonstrate that equality, diversity and socio –economic factors have duly been considered when preparing this report.

6.4 **Sustainable Development Goals**
The recommendations of this report, per the Funds Responsible Investment Policy, will further strengthen the Funds commitment to sustainable investment.

6.5 **Climate Change**
The recommendations of this report, per the Funds Responsible Investment Policy, will further strengthen the Funds commitment to reducing climate change.

6.6 **Rural Proofing**
It is anticipated there will be no adverse impact on the rural area from the contents of this report.

6.7 **Data Protection Impact Statement**
There are no personal data implications arising from the proposals contained in this report.

6.8 **Changes to Scheme of Administration or Scheme of Delegation**
No changes are required as a result of this report.

7 CONSULTATION

7.1 The Monitoring Officer/Chief Legal Officer, the Chief Officer Audit and Risk, the Service Director HR & Communications, the Clerk to the Council and Corporate Communications are currently being consulted and any comments received will be reported at the meeting.

Approved by

David Robertson **Signature …….**
Executive Director, Finance and Regulatory

Author(s)

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Background Papers:
Previous Minute Reference: Pension Fund Committee and Pension Fund Board, 13 September 2018

Note – You can get this document on tape, in Braille, large print and various computer formats by contacting the address below. The Pension & Investment Team

can also give information on other language translations as well as providing additional copies.

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